

Michael D. Braun (CA Bar #167416)
BRAUN LAW GROUP, P.C.
12400 Wilshire Blvd., Suite 920
Los Angeles, CA 90025
Tel: (310) 442-7755
Fax: (310) 442-7756

Liaison Counsel for Plaintiff and the Class

Maya Saxena
Joseph E. White III
SAXENA WHITE P.A.
2424 North Federal Highway, Suite 257
Boca Raton, FL 33431
Tel: (561) 394-3399
Fax: (561) 394-3382

Michael A. Swick
Kim E. Miller (CA Bar #178370)
KAHN GAUTHIER SWICK, LLC
12 East 41st St., 12th Floor
New York, NY 10017
Tel: (212) 696-3730
Fax: (504) 455-1498

Lewis Kahn
KAHN GAUTHIER SWICK, LLC
650 Poydras Street, Suite 2150
New Orleans, LA 70130
Tel: (504) 455-1400
Fax: (504) 455-1498

Lead Counsel for Plaintiff and the Class

**UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA**

ADRIAN MONGELI, Individually, And)
On Behalf Of All Others Similarly Situated,)

Plaintiff,)

vs.)

TERAYON COMMUNICATION)
SYSTEMS, INC., ZAKI RAKIB, JERRY)
D. CHASE, MARK A. RICHMAN,)
EDWARD LOPEZ, RAY FRITZ, CAROL)
LUSTENADER, MATTHEW MILLER,)
SHLOMO RAKIB, DOUG SABELLA,)
CHRISTOPHER SCHAEPE, MARK)
SLAVEN, LEWIS SOLOMON, HOWARD)
W. SPEAKS, ARTHUR T. TAYLOR,)
DAVID WOODROW, and ERNST &)
YOUNG, LLP)

Defendants.)

CASE NO.: 3-06-CV-03936 MJJ

CLASS ACTION

**LEAD PLAINTIFF'S MEMORANDUM OF
POINTS AND AUTHORITIES IN
OPPOSITION TO MOTION OF ERNST &
YOUNG TO DISMISS AMENDED CLASS
ACTION COMPLAINT**

DATE: July 24, 2007
TIME: 9:30 A.M.
CTRM: 11, 9th Floor

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1 Plaintiff Adrian Mongeli ("Plaintiff") respectfully submits his Memorandum of Points and
2 Authorities in Opposition to the Motion of Ernst & Young, LLP ("E&Y") to Dismiss the Amended
3 Class Action Complaint ("Complaint").

4 **I. PRELIMINARY STATEMENT**

5 In its Memorandum of Points and Authorities in Support of Its Motion to Dismiss the Amended
6 Class Action Complaint ("E&Y's Brf."), E&Y argues that the Complaint should be dismissed because
7 Plaintiff has failed to plead particularized facts giving rise to a strong inference that E&Y acted with
8 scienter, as required under the Private Securities Litigation Reform Act of 1995 ("PSLRA"). E&Y's
9 motion to dismiss should be denied in its entirety because Plaintiff has adequately alleged all of the
10 required elements for claims under the Securities Exchange Act of 1934 ("Exchange Act") and has pled
11 particularized facts giving rise to a strong inference that E&Y acted with scienter with respect to its
12 participation in the accounting fraud at Terayon Communication Systems, Inc. ("Terayon" or "the
13 Company), as required by the PSLRA.

14 Plaintiff asserts that E&Y, Terayon's independent outside auditor, participated in a scheme to
15 defraud the Company's shareholders who purchased Terayon securities between June 28, 2001 and
16 March 1, 2006 (the "Class Period"). Plaintiff contends that during the Class Period, Defendants
17 knowingly or recklessly published a series of statements which were materially false and misleading
18 at the time of such publication, and which omitted information necessary to legitimize Defendants'
19 statements in light of such omissions. Plaintiff further alleges that several individual defendants
20 engaged in improper insider sales, collectively reaping millions of dollars in proceeds at the direct
21 expense of Plaintiff and the class.

22 Within the Class Period and until its surprising resignation as Terayon's auditor in September
23 2005, E&Y was a necessary, indeed critical, aid in Terayon's fraudulent scheme to artificially inflate
24 the stock price of the Company through materially false and misleading statements with respect to
25 purported record-setting financial results and projections. In truth, these results were attributable to
26 improper accounting practices – including improper revenue recognition – which resulted in a
27 significant and material overstatement of Terayon's revenues.

28

1 Although obvious warning signs of these improper accounting practices abounded, E&Y
2 intentionally or with deliberate recklessness ignored the “red flags” that were present at Terayon prior
3 to and during the Class Period. These warning signs included, among others, an earlier settlement of
4 a securities fraud action involving the same cast of characters (“Terayon Earlier Securities Fraud
5 Action”), numerous GAAP violations, suspicious insider sales amounting to nearly \$4 million in
6 proceeds, resistance to application of correct accounting principles which would have had a negative
7 effect on financial results, as well as a complete lack of internal controls and procedures, ultimately
8 leading to a formal SEC investigation, the delisting of Terayon from the NASDAQ, and a restatement
9 of 72 months’ worth of financial results. Had E&Y fulfilled its obligations as Terayon’s independent
10 outside auditor, such “red flags” would have raised E&Y’s suspicions and would have forced it to
11 conduct significant testing and review of Defendants’ financial disclosures and reports.

12 Despite the prevalence of these warning signs, and in violation of its duties as an independent
13 outside auditor, E&Y failed to ask the appropriate and necessary questions which a reasonable and
14 independent auditor would inquire in the course of due diligence, failed to disclose any material
15 problems with Terayon’s financial reporting until just months prior to its abrupt resignation, and failed
16 to deliver a public objection to the Company’s characterization of certain control deficiencies as one-
17 time events that had already been substantially remedied or cured, and that were not expected to
18 continue to have a material impact on the Company or its financial reporting.

19 Because E&Y was the sole independent auditor during the majority of the Class Period, class
20 members relied on the veracity of E&Y’s confirmations that Terayon was reporting accurate financial
21 results in accordance with GAAP when they purchased Terayon securities. Investors relied on those
22 results, confirmed by E&Y, showing that the Company’s business was growing in key areas. As a
23 result, class members suffered millions of dollars in losses when they learned that Terayon had been
24 reporting false and misleading financial results throughout the Class Period with E&Y’s full knowledge
25 and participation.

26 ///

27 ///

28 ///

II. STATEMENT OF ISSUE PRESENTED

Whether the Complaint adequately states claims under the Exchange Act against E&Y where the alleged material misrepresentations and omissions of E&Y, along with its intentional or deliberately reckless ignorance of obvious “red flags” concerning Terayon’s fraudulent accounting practices and improper insider sales, when taken as a whole, support a strong inference of scienter.

III. STANDARD OF REVIEW

Motions to dismiss are viewed with disfavor and particular skepticism to ensure that plaintiffs are not denied a full and fair opportunity to present their claims. *Hall v. City of Santa Barbara*, 833 F.2d 1270, 1274 (9th Cir. 1986). In considering a motion to dismiss, all allegations of material facts in the complaint are taken as true and construed in the light most favorable to the plaintiff. *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 983 (9th Cir. 1999). A complaint should not be dismissed unless it appears beyond a doubt that the plaintiff cannot prove any set of facts in support of the claim that would entitle him to relief. *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 931 (9th Cir. 2003). The Court cannot parse and dismiss each allegation one by one. Rather, it must determine whether in the final analysis, “the total of plaintiffs’ allegations . . . [is] sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness.” *In re Dura Pharms., Inc. Sec. Litig.*, 452 F. Supp. 1005, 1017 (S.D. Cal. 2006) (emphasis added) (quotations and citations omitted).

IV. ARGUMENT

A. Plaintiff Has Properly Pled Violations of the Exchange Act Against E&Y

E&Y argues that Plaintiff failed to properly plead claims against E&Y for violations of Section 10(b) of the Exchange Act because he has failed to particularize his charge of fraud under Rule 9(b) and failed to plead facts giving rise to a strong inference that E&Y acted with scienter. E&Y’s Brf. at 5. E&Y’s argument is untenable because, as set forth in greater detail below, Plaintiff has pled facts in support of his allegations sufficient to satisfy the pleading standards of the PSLRA.¹

¹ E&Y has joined in the Motion to Dismiss of Terayon Communication Systems, Inc. and the Individual Defendants with respect to the loss causation arguments presented therein. (E&Y’s Brf. at 1). Accordingly, Plaintiff incorporates by reference Section IV.C of his Opposition to the

Pursuant to the PSLRA, a complaint must specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information, the complaint shall state with particularity all facts on which the belief is formed. *See* 15 U.S.C. § 78u-4(b)(1). By alleging with particularity E&Y's materially misleading statements and omissions that allowed Terayon to publish projections and financial results that were seriously flawed, misleading and lacking in rational basis, Plaintiff has met his pleading burden under the PSLRA.

Plaintiff alleges that, during the Class Period, Defendants published a series of statements which were materially false and misleading when published, and which omitted information necessary to make Defendants' statements not materially false and misleading. Plaintiff further contends that at the time these false and misleading statements were being issued throughout the Class Period – which artificially inflated the price of Terayon stock – several of the individual defendants were engaging in improper insider sales, collectively reaping millions of dollars in proceeds at the direct expense of the class members. Despite E&Y's obligations as Terayon's outside auditor to properly test and review the Company's disclosures and reports, and disclose any material problems with the Company's financial reporting, E&Y intentionally or with deliberate recklessness ignored the numerous "red flags" that surrounded Terayon during the Class Period. These improprieties were clear warning signs which should have raised E&Y's suspicions in order to protect the interests of the investing public.

E&Y cites cases and articulates relevant pleading principles but offers no meaningful analysis of the facts alleged in the Complaint. It is not enough for E&Y to simply quote legal standards; it must analyze the totality of the allegations related to its conduct. Moreover, E&Y conveniently glosses over a number of significant allegations that support a strong inference of scienter.

Motion to Dismiss of Terayon Communication Systems, Inc. and the Individual Defendants, Docket No. 53. Furthermore, Defendants' and E&Y's loss causation defense is fact-sensitive and cannot be appropriately determined at this stage of the proceedings. *See In re Consol. Capital Sec. Litig.*, No. C 85 7332 AJZ, 1990 U.S. Dist. LEXIS 19864 (N.D. Cal. Feb. 26, 1990); *Lilley v. Charren*, 936 F. Supp. 708, 718 (N.D. Cal. 1996) ("Plaintiffs allege that as a result of false and misleading statements Kenetech securities were artificially inflated in price for two years, and include other allegations relating to causation throughout the complaint. At this preliminary pleading stage, these allegations are sufficient") (citations omitted).

1 E&Y's argument fails because Plaintiff has identified, in significant detail, the material
2 misrepresentations, omissions and violations that E&Y committed during the Class Period:

- 3 - Throughout the Class Period, E&Y knew that its audit reports would be
4 disseminated to and relied upon by investors, and that it owed duties to
5 Terayon's investors as the outside independent auditor for the Company. (*See*,
6 *e.g.*, ¶¶ 16, 49).
- 7 - The allegations of fraud and misrepresentation in the Terayon Earlier Securities
8 Fraud Action raised significant red flags and ongoing concerns regarding the
9 accuracy and completeness of the Company's disclosures and the adequacy of
10 the Company's controls and procedures, and these red flags should have caused
11 E&Y to approach Terayon's audits with a very high level of skepticism and to
12 critically approach Defendants' disclosures and representations – especially
13 those related to revenues and related-party transactions. (*See, e.g.*, ¶¶ 46-49).
- 14 - E&Y knew or recklessly disregarded that the Terayon insiders' stock sales were
15 highly unusual in their timing and amounts, and ignored these obvious
16 cautionary signs that would have allowed it to uncover Defendants' accounting
17 fraud. (*See, e.g.*, ¶¶ 3, 50-51, 263-64).
- 18 - A former Terayon employee in the accounting department during the Class
19 Period revealed that E&Y "was not clean on this stuff", "virtually closed the
20 books for year end 2001 and 2000 – a 'no-no'", "did not try to learn the
21 Company's business", provided recommendations on goods received but not
22 invoiced that were "not valid – they should have been amortized over time",
23 provided invalid instructions with respect to the Thomson transaction in order
24 to appease Terayon's desire to recognize the revenue from the transaction
25 immediately, failed to ask the appropriate and necessary questions in the course
26 of its due diligence, failed to insist on the application of SOP 97-2 with regard
27 to software revenue recognition, did not focus on the Terayon account and did
28 not have any material discussions with the vice president of Terayon who ran
each of its three business areas. (*See, e.g.*, ¶¶ 52-55).
- E&Y was motivated to conceal the Defendants' accounting fraud because the
auditor did not want to lose millions of dollars in professional fees from the
Terayon account, nor risk having the reputation of exposing its own clients to
regulatory, civil or criminal sanctions, thereby potentially costing it future clients
and revenue. (*See, e.g.*, ¶¶ 5, 17, 57-58).
- E&Y's statements and confirmations contained in Terayon's SEC filings during
the Class Period were each materially false and misleading when made because
the financial statements, projections and operations reports were *not* true,
accurate or reliable, the financial statements were *not* GAAP compliant,
Terayon's internal financial accounting and disclosure controls were grossly
inadequate and ineffective, E&Y failed to properly test such internal controls
and procedures, and Terayon's internal control deficiencies were material and
pervasive. (*See, e.g.*, ¶¶ 1, 2, 4, 5, 17, 59, 64, 148, 149, 195).

Accordingly, the Complaint identifies with particularity E&Y's duties as the independent outside auditor for Terayon, the warning signs that E&Y ignored which would have led a reasonably independent and unbiased outside auditor to uncover Defendants' accounting fraud, the particulars of the statements and omissions at issue in the Complaint, the documents in which these statements were contained, and the reasons why the statements were false and misleading.

B. Plaintiff's Allegations Raise a Strong Inference of Scienter

The PSLRA requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). In this Circuit, the "required state of mind" is one of "deliberate or conscious recklessness." *Silicon Graphics*, 183 F.3d at 979. Scienter may be inferred from the same set of facts that allege the falsity of the relevant statements. *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2002) (pleading requirements under the PSLRA can be collapsed into a single inquiry because analysis of both requirements involves the same set of facts). Drawing all reasonable inferences in favor of the plaintiff, the court can then "answer the larger question of whether [the] complaint, considered in its entirety, states facts which give rise to a strong inference of deliberate recklessness," or knowledge. *Silicon Graphics*, 183 F.3d at 980 n.11, 983, 985.

E&Y's analysis concerning the adequacy of Plaintiff's individual scienter allegations is flawed because it considers such allegations in a vacuum without examination of the larger picture. E&Y dismisses each of these allegations one by one as failing to meet the particularity requirements of the PSLRA. However, the individual allegations collectively, and the Complaint as a whole, should be analyzed in assessing whether Plaintiff has pled particularized facts sufficient to support a strong inference of scienter:

Under *Silicon Graphics* and its progeny, we examine *all the circumstances* in determining whether a strong inference of scienter has been raised.... Beyond each individual allegation, we also consider whether the *total of plaintiffs' allegations*, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness.

Am. West, 320 F.3d at 937-38 (internal quotation marks and citations omitted) (emphasis added); *see also Ronconi*, 253 F.3d at 429 ("In considering whether a private securities fraud complaint can survive

dismissal under Rule 12(b)(6), we must determine whether particular facts in the complaint, taken as a whole, raise a strong inference that defendants intentionally or [with] deliberate recklessness made false or misleading statements.”) (internal quotation marks and citations omitted). Additionally, several factors may be considered in assessing the sufficiency of scienter allegations with respect to an auditor in particular:

With regard to sufficiently alleging scienter against auditors, courts have held that in assessing the totality of the circumstances the following may each contribute in supplying an inference that an auditor performed a reckless or fraudulent audit: 1) red flags regarding accounting matters, 2) restated financial statements, 3) an auditor's failure to obtain sufficient support for account balances, and 4) an auditor's failure to follow-up on known accounting errors.

In re Fleming Cos. Secs. & Derivative Litig., No. 5-03-MD-1530 (TJW), MDL-1530, 2004 U.S. Dist. LEXIS 26488 at *116 (E.D. Tex. June 10, 2004) (citations omitted).

Considered in their entirety, the facts alleged here raise a strong inference of E&Y's scienter. The Complaint alleges that Defendants participated in a scheme to overstate the Company's revenues which artificially inflated the stock price of the Company. E&Y legitimized the scheme by issuing unqualified opinions on Terayon's financials despite evidence that the Company's controls and procedures and, as a result, the Company's projections and reported financial results, were seriously flawed, misleading and lacking in rational basis. Plaintiff has set forth facts alleging that E&Y utterly ignored obvious cautionary signs that would have allowed it to uncover Defendants' accounting fraud and the complete lack of internal controls and procedures that ultimately forced Terayon to restate 72 months of financial results. (*See, e.g.*, ¶¶ 17, 49-56, 195).

Taken as a whole, the Complaint alleges, in specific detail, a scheme employed by Defendants to publish materially false and misleading statements which artificially inflated the price of Terayon stock. Additionally, Plaintiff has bolstered his scienter allegations by pleading that E&Y had motive to participate in the Terayon accounting fraud, that Terayon's public filings are replete with violations of GAAP and related abuses, and that E&Y intentionally or with deliberate recklessness ignored the many cautionary signs that should have alerted it to such violations. (*See, e.g.*, ¶¶ 4, 5, 17, 55-59, 64, 77, 91, 195, 212, 244, 254-61).

1 **1. E&Y Had Motive to Participate in the Terayon Accounting Fraud**

2 E&Y argues that it lacked any incentive to participate in the alleged fraud and that, because of
3 E&Y's purported lack of motive, Plaintiff's scienter allegations are necessarily contradicted. *See*
4 E&Y's Brf. at 16-17. Specifically, E&Y dismisses as "irrational" Plaintiff's allegations that E&Y was
5 motivated to participate in the alleged fraud in order to collect millions of dollars in professional fees
6 and avoid subjecting a client to possible civil and criminal liability, leading to a potential loss of future
7 business. *Id.*

8 Although motive allegations alone do not conclusively establish scienter, Plaintiff has pled
9 substantial instances of Defendants' material misrepresentations and omissions in addition to motive
10 allegations. *See, supra*, Section IV.A. E&Y's motive and opportunity to participate in the Terayon
11 accounting fraud, when combined with material misrepresentations and omissions, contribute to a
12 strong inference of scienter. *See In re Nuko Info. Sys., Inc. Sec. Litig.*, 199 F.R.D. 338, 343 (N.D. Cal.
13 2000) ("motive and opportunity coupled with highly material misrepresentations or omissions may well
14 satisfy the standard"); *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 931 (9th Cir. 1993) (motive and
15 opportunity may contribute to an inference not just of recklessness, but "specific intent to commit . . .
16 fraud").

17 Moreover, E&Y is wrong in suggesting that it could have no sufficient motive to engage in
18 securities fraud. Any notion that auditors' fees cannot serve as such a motive has been more than
19 discredited by the numerous other recent examples of securities frauds implicating auditors:

20 The final allegation on which plaintiffs rely is PwC's motivation to
21 overlook S&W's concealment of losses in order to protect its own source
22 of lucrative accounting and consulting fees. We do not doubt that such
23 a profit motive could contribute to an auditor's decision to turn a [blind]
24 eye to a corporation's misleading accounting. Such allegations can thus
strengthen an inference of scienter predicated on other facts, possibly
adding sufficient strength to satisfy the strong-inference requirement of
[the] PSLRA.

25 *In re Stone & Webster, Inc., Sec. Litig.*, 414 F.3d 187, 215 (1st Cir. 2005) (internal quotations and
26 citations omitted); *see also In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2003 U.S. Dist.
27 LEXIS 10863, at *13 (S.D.N.Y. June 25, 2003) ("Andersen was well paid for its WorldCom work").
28 E&Y's no-possible-motive argument is nothing short of a contention that auditors who are paid large

1 but customary professional fees for their audits cannot violate the securities laws. Nothing in the
2 PSLRA comes close to supporting such an extreme view.

3 **2. Plaintiff's Allegations of E&Y's Role in the Scheme Satisfy the Scierter**
4 **Pleading Requirement**

5 In addition to possessing motive to participate in the Terayon accounting fraud, E&Y does not
6 and cannot rebut the inference that it acted with conscious or deliberate recklessness given the multitude
7 of obvious cautionary signs that would have alerted a truly independent outside auditor to the
8 accounting improprieties and securities fraud taking place within Terayon. E&Y audited the Terayon
9 financial statements prior to and during the Class Period up until its abrupt resignation as the
10 Company's outside auditor in September 2005. However, as it admits, E&Y did not publicly identify
11 or disclose any deficiencies in Terayon's internal controls or express any adverse opinions on the
12 Company's financial results until Terayon's Form 10-Q was filed on November 15, 2004. E&Y's Brf.
13 at 11. This was more than three years after the beginning of the Class Period and only months prior to
14 E&Y's suspicious resignation as Terayon's independent outside auditor. Predictably, months later
15 Terayon disclosed to the investing public that the Company would have to restate 72 months of
16 financial results during the Class Period due to rampant accounting violations.

17 Under these circumstances, E&Y's audit of Terayon's financial statements during the Class
18 Period amounted either to no audit at all, or an egregious failure to see the obvious and investigate the
19 Defendants' admittedly misleading accounting practices. In such cases of utter failure, the Ninth Circuit
20 has affirmed Section 10(b) and Rule 10b-5 claims against outside auditors. *See, e.g., Ponce v. S.E.C.*,
21 345 F.3d 722 (9th Cir. 2003); *In re Software Toolworks, Inc.*, 50 F.3d 615 (9th Cir. 1994) (scierter
22 requirement for a claim of deceptive conduct by the accountant was pled where allegations showing that
23 the accounting practices of the auditor were so deficient that the audit amounted to no audit at all, or
24 an egregious refusal to see the obvious, or to investigate the doubtful).

25 E&Y's argument that Plaintiff has failed to properly plead particularized facts and allegations
26 are further undercut by the numerous authorities that support the sufficiency of Plaintiff's scierter
27 allegations. In *Am. West*, the court held that allegations regarding the defendants' misleading
28 statements, when taken as a whole, met the stringent pleading standard of the PSLRA: "In this era of

1 corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants,
 2 we are cautious not to raise the bar of the PSLRA any higher than that which is required under its
 3 mandates.” 320 F.3d at 945-46. *See also Nuko Info.*, 199 F.R.D. 338 (plaintiffs who alleged overstated
 4 revenues sufficiently alleged motive and opportunity, facts strongly suggesting that defendants knew
 5 they were overstating revenues and that it was improper for them to do so, and violations of GAAP
 6 regarding those transactions); *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal.
 7 2003) (allegations sufficiently gave rise to a strong inference that the auditor acted with deliberate
 8 recklessness and that the auditor’s conduct amounted to an egregious refusal to see the obvious when
 9 it issued its audit opinion and substantially participated in the preparation of various quarterly reports).

10 Furthermore, the court in *Fleming Cos.* found that the allegations against an auditor, when taken
 11 as a whole, adequately pled scienter. The court found significant the auditor’s duties to obtain and
 12 evaluate evidence concerning the assertions made in its client’s financial statements:

13 Independent auditors are charged with obtaining and evaluating evidence
 14 concerning the assertions made in their client’s financial statements.
 15 Auditors are not entitled to allow representations from a company’s
 16 management to substitute for the auditing procedures that are necessary
 17 to provide a reasonable basis for forming an opinion regarding the
 18 financial statements that are the subject of the audit.... Professional
 19 auditors are required to act diligently and in good faith, and to apply a
 professional skepticism to their evaluation of evidence. An auditor
 should conduct the audit objectively, thoroughly and carefully. Before
 certifying financial statements, an auditor should have an understanding
 of the factors that may have a significant effect on the financial
 statements.

20 2004 U.S. Dist. LEXIS 26488, at *121-22 (citations omitted). If E&Y had evaluated properly the
 21 obvious cautionary signs of improprieties prevalent in Terayon during the Class Period, it would have
 22 discovered Defendants’ fraudulent accounting practices: “[t]he allegations identifying the steps
 23 Andersen should have taken and failed to take, and the fraud it would have discovered if it had taken
 24 those steps, create a strong inference that Andersen acted recklessly in conducting the WorldCom
 25 audits.” *Worldcom*, 2003 U.S. Dist. LEXIS 10863, at *22; *see also Novak v. Kasaks*, 216 F.3d 300, 308
 26 (2d. Cir. 2000) (allegations that defendants “failed to review or check information that they had a duty
 27 to monitor, or ignored obvious signs of fraud” are sufficient to allege recklessness).

1 **3. The Terayon Insiders' Sales Support a Strong Inference of Scienter**

2 Plaintiff incorporates by reference Section IV.A.2 from his Opposition to the Motion to Dismiss
3 of Terayon Communication Systems, Inc. and the Individual Defendants, Docket No. 53. E&Y argues
4 that Plaintiff failed to set forth allegations sufficient to infer that E&Y intentionally or with deliberate
5 recklessness ignored evidence of fraud from insider stock sales. However, Plaintiff alleges, in
6 significant detail, particularized facts sufficient to infer that E&Y consciously ignored the suspicious
7 nature of the insider sales.

8 The allegations include, among others, the improper insider sales which formed a basis for the
9 Terayon Earlier Securities Fraud Action; the suspicious sales of the Terayon insiders during the Class
10 Period, including 300,000 shares by the Rakib brothers alone in February of 2005 – nearly *double* the
11 number of shares sold by all insiders in the Terayon Earlier Securities Fraud Action; and the timing of
12 these suspicious insider sales when Defendants were already contemplating the restatement, an SEC
13 investigation was entirely foreseeable, and the Terayon Earlier Securities Fraud Action had not yet
14 settled for \$15 million. (*See, e.g.*, ¶¶ 3, 46-51, 235, 263-64).

15 Given this backdrop of improper and fraudulent business activity, the insider sales were highly
16 questionable and should have raised the suspicions of E&Y. A reasonable and independent outside
17 auditor would have inquired as to the propriety of these insider sales, thereby exposing the fraud taking
18 place at Terayon. Accordingly, E&Y's intentional or deliberately reckless ignorance of the evidence
19 of fraud from the Terayon insider stock sales provides additional support for a strong inference of
20 scienter.

21 **4. Allegations Based on Statements from a Former Employee in the**
22 **Accounting Department Support a Strong Inference of Scienter**

23 Plaintiff incorporates by reference Section IV.A.5 from his Opposition to the Motion to Dismiss
24 of Terayon Communication Systems, Inc. and the Individual Defendants, Docket No. 53. In addition
25 to questioning the specificity with which Plaintiff described the former employee who worked in
26 Terayon's accounting department during the Class Period, E&Y also questions whether the assertions
27 of the employee create a strong inference of scienter. While Plaintiff has identified his confidential
28

1 source with sufficient particularity to satisfy the PSLRA, the allegations attributed to this source also
2 support a strong inference of scienter against E&Y.

3 In particular, the statements from the former employee reveal significant violations of GAAP
4 and general SEC reporting rules and regulations, improper revenue recognition and accounting direction
5 with respect to several accounts and transactions, and conversations between E&Y and Defendants
6 which confirm that E&Y allowed Defendants' biased judgments, inaccurate representations and
7 compromised agendas to substitute its own due diligence and investigation in applying proper
8 accounting principles. (*See, e.g.*, ¶¶ 52-55). Such deficiencies and failures are corroborated by
9 Defendants' own concessions in the restatements of the Terayon Class Period financial reports.
10 Moreover, the specificity of the former employee's statements makes it clear that E&Y was aware of
11 the obvious cautionary signs present in Terayon during the Class Period and failed to respond to such
12 red flags in a manner consistent with its duties and obligations as the sole independent outside auditor
13 for Terayon. Accordingly, the former employee's statements provide a strong inference of scienter.

14 **5. E&Y's Knowledge or Reckless Disregard of Terayon's Problems May Be**
15 **Inferred from E&Y's Failure to Recognize and Respond to Red Flags**

16 Plaintiff alleges that E&Y consciously or with deliberate recklessness ignored the obvious
17 warning signs concerning Terayon's allegedly fraudulent financial reporting during the Class Period.
18 E&Y dismisses these allegations, stating that none of these signs "demonstrates that E&Y acted either
19 intentionally or with deliberate recklessness." E&Y's Brf. at 8. Indeed, E&Y's method of attacking
20 Plaintiff's allegations is to analyze one piece of the puzzle and conclude that this single element, by
21 itself, is not sufficient to support an inference of scienter. However, such allegations cannot be
22 examined in a vacuum without reference to the rest of the puzzle in which E&Y's conscious or
23 deliberately reckless behavior is clear and a strong inference of scienter is presented.

24 E&Y's conscious or deliberately reckless behavior can be inferred from the "specific, highly
25 suspicious facts and circumstances available to the auditor at the time of the audit." *In re SmarTalk*
26 *Teleservs., Inc. Sec. Litig.*, 124 F. Supp. 2d 505, 514 (S.D. Ohio 2000). Furthermore, ignoring copious
27 "red flags" also gives rise to an inference of scienter. *Miller v. Material Scis. Corp.*, 9 F. Supp. 2d 925,
28 928 (N.D. Ill. 1998) ("Deliberately ignoring 'red flags' . . . can constitute the sort of recklessness

1 necessary to support § 10(b) liability.”); *Danis v. USN Communs., Inc.*, 73 F. Supp. 2d 923, 942 (N.D.
 2 Ill. 1999) (“Plaintiffs sufficiently allege the existence of and Deloitte’s awareness of these ‘red flags’
 3 Deloitte’s knowledge or reckless disregard of USN’s problems may be inferred.”); *In re*
 4 *Transcrypt Int’l Sec. Litig.*, No. 4:98CV3099, 1999 U.S. Dist. LEXIS 17540, at *27-28 (D. Neb. Nov.
 5 4, 1999) (failure to notice numerous red flags demonstrates an auditor’s recklessness); *CMNY Capital,*
 6 *L.P. v. Deloitte & Touche*, 821 F. Supp. 152, 166 (S.D.N.Y. 1993) (“red flags” support an inference of
 7 scienter).

8 The numerous red flags throughout the Class Period regarding Terayon’s accounting
 9 improprieties and securities fraud included, among others, the settlement of the Terayon Earlier
 10 Securities Fraud Action, violations of GAAP and SEC reporting rules and regulations, suspicious
 11 insider sales, resistance to application of SOP 97-2, improper revenue recognition and third-party
 12 transactions, and ineffective internal controls and procedures, all culminating in the restatement of 72
 13 months of Terayon financial reports. Such extensive warning signs contribute to a finding of E&Y’s
 14 scienter:

15 The fact that an auditor ignored red flags constitutes strong evidence of
 16 intentional or reckless conduct. Although the existence of a restatement
 17 may not by itself satisfy the scienter requirement, a restatement can tip
 18 the scales in favor of a finding of scienter when the restatement is
 19 viewed with the totality of the circumstances surrounding the
 restatement. A restatement adds significant weight to the scienter
 calculus due to the magnitude of a restatement, the repetitiveness of
 GAAP violations requiring the restatement, and the simplicity of the
 accounting principles that were violated.

20 *Fleming Cos.*, 2004 U.S. Dist. LEXIS 26488, at *116-17 (citations omitted). Because the Complaint
 21 is replete with allegations of red flags and support for the conclusion that E&Y’s conduct amounted to
 22 no audit at all or refusal to see the obvious or investigate the doubtful, Plaintiff has properly pled
 23 scienter.

24 **6. E&Y’s Failure to Follow GAAP Provides Independent Proof of Scienter**

25 Plaintiff incorporates by reference Section IV.A.1 from his Opposition to the Motion to Dismiss
 26 of Terayon Communication Systems, Inc. and the Individual Defendants, Docket No. 53. E&Y’s
 27 deliberately reckless or intentional failure to follow GAAP resulted in the filing of materially false
 28 financial statements, providing an independent basis by which to find E&Y liable under Section 10(b).

1 E&Y argues that GAAP violations, without more, do not establish scienter, citing to *DSAM Global*
2 *Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002) in support. E&Y's Brf. at 9.
3 However, *DSAM* is distinguishable from the instant action in that the plaintiff there failed to allege *any*
4 facts other than the GAAP violations to establish that the auditor acted with scienter. *DSAM*, 288 F.3d
5 at 390-91. Furthermore, the auditor in *DSAM* withdrew its audit opinion immediately upon learning
6 of such accounting violations. *Id.* at 388.

7 E&Y attempts to distort the content of Plaintiff's assertions and examines the allegations of
8 GAAP violations without context. Such characterization is an effort to mask obvious improprieties and
9 violations with the argument that this allegation, alone, is not sufficient to meet the standards of the
10 PSLRA.

11 Moreover, this Circuit has held that GAAP violations, combined with other circumstances
12 indicating unlawful activities, provide strong circumstantial evidence of scienter. *See In re McKesson*
13 *Hboc, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1272-73 (N.D. Cal. 2000) ("[W]hen significant GAAP
14 violations are described with particularity in the complaint, they may provide powerful indirect evidence
15 of scienter. After all, books do not cook themselves."); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077,
16 1082-83 (N.D. Cal. 2001) (GAAP violations that "constituted a widespread and significant inflation of
17 revenue . . . a strong inference arises that senior management intentionally misstated earnings"). Even
18 E&Y's own reference to *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994),
19 suggests as much: "alleged violations of GAAP or SEC regulations, *without more*, do not establish
20 scienter." E&Y's Brf. at 9 (emphasis added). E&Y's violations with respect to the Terayon accounting
21 fraud include much more than a mere honest error in accounting or judgment by a truly independent
22 outside auditor.

23 Additionally, the huge magnitude of the misrepresented financial information also supports a
24 strong inference of scienter. *See, e.g., Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill.
25 1997) (large accounting errors strengthen inference of scienter). In *In re First Merchs. Acceptance*
26 *Corp. Sec. Litig.*, No. 97 C 2715, 1998 U.S. Dist. LEXIS 17760, at * 30-32 (N.D. Ill. Nov. 4, 1998),
27 the court held that allegations of specific GAAP violations, combined with other circumstances
28 suggesting fraudulent intent, constituted strong circumstantial evidence of scienter.

Here, Plaintiff specifically pleads that Terayon's semi-annual and annual reports and other public filings during the Class Period violated GAAP. (*See, e.g.*, ¶¶ 4, 59, 64, 77, 91, 195, 212, 244, 254-61). Plaintiff further alleges that as a direct result of Terayon's GAAP violations, the Company's public filings during the Class Period were necessarily false and misleading. Furthermore, as a result of Defendants' GAAP violations, Terayon was ultimately required to restate 72 months' worth of financial reports, the Company was delisted from the NASDAQ, and the SEC launched a formal investigation of the Company. When the truth finally emerged, a financial picture that was materially different from that which Defendants and E&Y publicly represented throughout the Class Period came to light. Accordingly, the magnitude of E&Y's failures during the Class Period provides strong circumstantial evidence of its scienter.

V. CONCLUSION

For all of the foregoing reasons, the Court should deny in its entirety E&Y's Motion to Dismiss the Amended Class Action Complaint. If any part of E&Y's motion is granted, Plaintiff respectfully requests leave to amend. *Eminence Capital, L.L.C. v. Aspeon, Inc.*, 316 F.3d 1048, 1051-53 (9th Cir. 2003).

Respectfully submitted,

Dated: May 7, 2007

Michael D. Braun
BRAUN LAW GROUP, P.C.

By: /S/
Michael D. Braun
12400 Wilshire Boulevard
Suite 920
Los Angeles, CA 90025
Tel: (310) 442-7755
Fax: (310) 442-7756

Liaison Counsel for Plaintiff and the Class

Maya Saxena
Joseph E. White III
SAXENA WHITE P.A.
2424 North Federal Highway, Suite 257
Boca Raton, FL 33431
Tel: (561) 394-3399
Fax: (561) 394-3382

1 Lewis Kahn
2 KAHN GAUTHIER SWICK, LLC
3 650 Poydras Street, Suite 2150
4 New Orleans, LA 70130
5 Tel: (504) 455-1400
6 Fax: (504) 455-1498

7 Michael A. Swick
8 Kim E. Miller
9 KAHN GAUTHIER SWICK, LLC
10 12 East 41st St., 12th Floor
11 New York, NY 10017
12 Tel: (212) 696-3730
13 Fax: (504) 455-1498

14 **Lead Counsel for Plaintiff and the Class**
15
16
17
18
19
20
21
22
23
24
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26
27
28

PROOF OF SERVICE

STATE OF CALIFORNIA)
COUNTY OF LOS ANGELES) ss.:

I am employed in the county of Los Angeles, State of California, I am over the age of 18 and not a party to the within action; my business address is 12400 Wilshire Boulevard, Suite 920, Los Angeles, CA 90025.

On May 7, 2007, using the Northern District of California's Electronic Case Filing System, with the ECF ID registered to Michael D. Braun, I filed and served the document(s) described as:

**LEAD PLAINTIFF'S MEMORANDUM OF POINTS AND AUTHORITIES IN
OPPOSITION TO MOTION OF ERNST & YOUNG TO DISMISS AMENDED CLASS
ACTION COMPLAINT**

The ECF System is designed to automatically generate an e-mail message to all parties in the case, which constitutes service. According to the ECF/PACER system, for this case, the parties served are as follows:

Lionel Z. Glancy, Esq. info@glancylaw.com

Michael M. Goldberg, Esq. info@glancylaw.com

Kim E. Miller, Esq. kim.miller@kgscounsel.com

Counsel for Plaintiffs

Patrick Edward Gibbs, Esq. patrick.gibbs@lw.com
zoila.aurora@lw.com

**Counsel for Defendant
Terayon Communication Systems, Inc.
and Individual Defendants**

Sheila Anil Jambekar, Esq. sjambekar@morganlewis.com

John H. Hemann, Esq. jhemann@morganlewis.com

Counsel for Defendant Ernst & Young LLP

On May 7, 2007, I served the document(s) described as:

**LEAD PLAINTIFF'S MEMORANDUM OF POINTS AND AUTHORITIES IN
OPPOSITION TO MOTION OF ERNST & YOUNG TO DISMISS AMENDED CLASS
ACTION COMPLAINT**

by placing a true copy(ies) thereof enclosed in a sealed envelope(s) addressed as follows:

///

///

///

1 Maya Saxena, Esq.
Joseph E. White III, Esq.
2 SAXENA WHITE P.A.
2424 North Federal Highway, Suite 257
3 Boca Raton, FL 33431
Tel: (561) 394-3399
4 Fax: (561) 394-3382

5 Lewis Kahn, Esq.
KAHN GAUTHIER SWICK, LLC
6 650 Poydras Street, Suite 2150
New Orleans, LA 70130
7 Tel: (504) 455-1400
Fax: (504) 455-1498

8 Michael A. Swick, Esq.
9 KAHN GAUTHIER SWICK, LLC
12 East 41st St., 12th Floor
10 New York, NY 10017
Tel: (212) 696-3730
11 Fax: (504) 455-1498

12 **Lead Counsel for Plaintiff**
Adrian G. Mongeli and the Class

13 Michael J. Lawson, Esq.
14 MORGAN, LEWIS & BOCKIUS LLP
One Market
15 Spear Street Tower
San Francisco, CA 94105
16 Tel: (415) 442-1000
Fax: (415) 442-1001

17 Bruce M. Cormier, Esq.
18 Joel E. Bonner, Esq.
ERNST & YOUNG LLP
19 1225 Connecticut Avenue, NW
Washington, D.C. 20036
20 Tel: (202) 327-7603
Fax: (202) 327-7601

21 **Counsel for Defendant**
22 **Ernst & Young LLP**

23 I served the above document(s) as follows:

24 BY MAIL. I am familiar with the firm's practice of collection and processing correspondence
for mailing. Under that practice it would be deposited with U.S. postal service on that same day with
25 postage thereon fully prepaid at Los Angeles, California in the ordinary course of business. I am aware
that on motion of the party served, service is presumed invalid if postal cancellation date or postage
26 meter date is more than one day after date of deposit for mailing in an affidavit.

1 I declare, pursuant to Civil L.R. 23-2, that on the date hereof I served a copy of the above-listed
2 document(s) on the Securities Class Action Clearinghouse by electronic mail through the following
3 electronic mail address provided by the Securities Class Action Clearinghouse:

4 **scac@law.stanford.edu**

5 I am employed in the office of a member of the bar of this Court at whose direction the service
6 was made.

7 I declare under penalty of perjury under the laws of the United States that the above is true and
8 correct.

9 Executed on May 7, 2007, at Los Angeles, California 90025.

10 /S/ LEITZA MOLINAR
11 Leitza Molinar
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22
23
24
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27
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